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SUBJECT: INFLATION AND A FIXED EXCHANGE RATE INCREASINGLY STRAIN EMBASSY OPERATIONS

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¶1. (SBU) Summary: Budgetary pressures stemming from Venezuela's unorthodox economic policies have strained Post's operations and will almost certainly pose stark choices for Post and the Department in the coming year. Inflation is high and growing, and the official exchange rate has been fixed at the same level for the past four years. As a result, the official dollar cost of a given good or service paid for in the local currency (the bolivar, or Bs) has risen on average by over 100 percent since 2005. Post has managed budgetary pressures thus far by converting many contracts from bolivars to dollars; using an ICASS carryover; and granting LES wage increases that are lagging behind inflation. We have already exhausted the benefits of these measures. With many economists predicting inflation of at least 40 percent in 2009, Post will need additional support to cover local procurements and to bring LES compensation up to the level of comparators as purchasing power drastically erodes. One measure providing immediate relief would be to pay LES in dollars. Absent an official devaluation, increased funding, or some other creative solution, Post may face a financial crisis before the end of FY 2009. End summary.

The Economic Background

¶2. (U) The Government of the Bolivarian Republic of Venezuela (GBRV) has maintained a fixed exchange rate regime with currency controls since 2003, last adjusting the rate from 1.92 to 2.15 Bs/USD in March 2005. At the same time, populist economic measures have caused inflation to increase, from 14 percent in calendar year (CY) 2005 to 31 percent in CY 2008 (ref A). From March 2005 through the present, prices have risen 110 percent on average. In other words, an item that cost Bs 215 in March 2005 might now cost Bs 450. Accounted for in dollars at the official rate, the increase would be from USD 100 to USD 210. Most local economists predict inflation of at least 40 percent in CY 2009 (ref B); some believe it could be as high as 60 percent. Many economists believe the GBRV will not devalue the currency in 2009, choosing instead to respond to low oil prices by restricting the quantity of dollars it sells at the official rate.

¶3. (U) Whenever currency controls exist, an alternative foreign exchange market develops. Venezuelan law offers a legal means for foreign exchange transactions on this parallel market via "swaps" of securities. The parallel market is growing in size as demand for dollars grows and the GBRV restricts the amount of dollars available at the official rate. The market is also highly volatile: the rate ranged from 2.5 to 3 Bs/USD from March 2005 to October 2006;

rose rapidly the ensuing 12 months to peak at 6.8 Bs/USD in November 2007; quickly plummeted to a fairly steady 3.4 Bs/USD from April to August 2008; and then rose steadily to its current level of 5.8 Bs/USD. At the current level, one USD is worth 2.5 times more Bs when exchanged on the parallel market than at the official rate. The GBRV has been the largest supplier of dollars to the parallel market, though the absence of a consistent intervention strategy is a leading cause of the market's volatility (ref C).

Embassy Accounting and Budget

¶4. (SBU) All Embassy operations are accounted for at the official rate. A local contract executed in Bs, for example, is converted to USD at the official rate for accounting purposes. Visa applicants may pay MRV fees in USD or in the equivalent in Bs at the official rate (obviously, almost all pay in Bs). As the Bs received through MRV fees far exceed the Bs needed for State operations (Bs 36.5 million vs. Bs 21.3 million for FY 2008), there is no need for the USG to change USD into Bs. Post understands that the USG, through an agreement with the Central Bank of Venezuela, is able to change excess Bs into USD at the official rate.

¶5. (SBU) Post's budget for State operations has declined roughly 5 percent over the period the exchange rate has been fixed at 2.15 Bs/USD, from USD 20.1 million in FY 2006 to USD 19 million expected for FY 2009. Embassy expenditures on State operations are currently more or less evenly split between USD and Bs (when converted to USD at the official rate). In FY 2008, the Embassy disbursed a total of USD 18.7

million (including obligations actually disbursed in FY 2009), of which roughly 53 percent was spent in bolivars (Bs 21.3 million, or USD 9.9 million at the official exchange rate). LES salaries are the largest expense in Bs, amounting to Bs 9.2 million (USD 4.3 million) in FY 2008. Contracts are the second-largest expense in Bs. (Note: The USD 400,000 difference between the amount budgeted and the amount disbursed for FY 2008 is primarily due to unused DS (USD 310,000) and MRV (USD 40,000) allocations. End note.)

Strains on Embassy Operations

¶6. (SBU) Inflation has presented challenges for companies and other institutions operating in Venezuela. The strain has been even more pronounced for the Embassy. Whereas companies can increase the bolivar prices of their products to keep pace with rising expenses, the Embassy's budget is fixed in USD and, as noted above, has declined slightly since FY 2006. If an Embassy services contract in Bs were to have increased at the same rate as inflation, to use the example of paragraph 2, the same services purchased with Bs equivalent of USD 100 in March 2005 would now cost the Bs equivalent of USD 210. While the increases have been less pronounced, even local goods and services the Embassy has traditionally acquired in USD are subject to inflationary pressure. The best example is dollar denominated apartment leases, which have been increasing 10 to 15 percent annually on average.

¶7. (SBU) The Embassy has managed the strain from rising prices in several ways over the past three years. First, LES compensation increases have been kept below inflation. The table below shows the average LES compensation increase and inflation for the last three FYs, all in percentage terms.

	LES Compensation Increase	Inflation
FY 2006	5.3	15.5
FY 2007	10.0	17.2
FY 2008	10.0	31.1
FY 2009	8.3	tbd

Over the last three years, therefore, even LES who qualify for Within Grade Increases (which have averaged about 5 percent a year) have not seen their compensation keep pace with inflation. The difference is significant from the Embassy's budgetary perspective. If LES had been granted an increase commensurate with inflation in FY 2008, the additional annual cost would be on the order of USD 900,000. (Note: The increases for FYs 2006 to 2008 went into effect in the spring of the respective year. For FY 2009, post requested an early compensation review given the impact of rising inflation on LES morale. The 8.3 percent increase subsequently granted went into effect in November 2009. End note.)

¶8. (SBU) In addition to LES compensation lagging behind inflation, the second way the Embassy has managed the strain is by converting key service contracts from Bs to USD starting in February 2008. Recent examples include contracts for cleaning, health insurance for local staff, and post language classes. The USD rate is set based on the cost of the services in Bs and an expected parallel foreign exchange rate. Thus, with an expected parallel rate of 5 Bs/USD, a contract that might have cost 50,000 Bs/month, or USD 23,000 at the official rate, only costs USD 10,000 per month. In this example, there would be a one-time annual savings of USD 120,000. From the three contracts mentioned above, the Embassy estimates it will realize one-time annual savings of USD 370,000, spread out over FYs 2008 and 2009. While conversion of these and other contracts have provided the Embassy with significant one-time savings, allowing us in effect to devote more funds to expenses we cannot convert to dollars, we have picked all the low-hanging fruit. How fast the USD cost of these contracts increases as they are renewed in the future depends on whether changes in the parallel rate keep up with local inflation.

¶9. (SBU) Finally, in some cases the Embassy has simply cut back on expenses in ways that reduce our effectiveness. Representation is a good example, though it represents only a small percentage of the overall budget. Prices for the food and hotels/restaurants categories are rising even faster than the general inflation index. In response, we have shifted the type and scale of the representational events we host and cut back on the number. (Note: We are beginning to implement a plan whereby U.S. direct-hire officers will be reimbursed for representational expenses in USD, with the parallel rate used to convert from Bs to USD. This plan will

stretch our severely depleted representational capacity. As is the situation with contracts, future year-on-year changes in representational capacity will depend on how changes in the parallel rate compare with inflation. End note.)

Difficult Choices Ahead

¶10. (SBU) The most critical strain on Embassy operations in 2009 will likely be related to LES compensation. If inflation remains in the 30 to 40 percent range as expected, LES purchasing power, already depleted over the past several years, could drop up to 50 percent before they receive another salary increase. Post may consequently need to request another early review, which we expect would show that compensation at comparators has risen at least 20 percent relative to the early FY 2009 review. If the official exchange rate remains unchanged, the Department must be prepared for a large increase in dollars allocated for LES compensation: a 20 percent increase (possibly below the expected increases for comparators) would amount to roughly an additional USD 900,000 on an annual basis.

¶11. (SBU) There is one step that would instantly raise LES purchasing power and increase morale without necessarily increasing compensation (in an accounting sense at least), namely paying LES salaries in dollars rather than bolivars. There would be no accounting cost to the USG and no actual cost as long as the Central Bank of Venezuela continued

converting excess Bs to USD at the official rate for the USG. Post understands the Department would not normally authorize payment in dollars unless comparators also predominantly paid in dollars (ref D). Anecdotal conversations indicate that an increasing number of multinational companies and embassies are paying some LES at least partially in hard currency. Post will follow up with comparators and other similar organizations and report septel on our findings and on other considerations specific to the issue of paying LES in dollars.

¶12. (SBU) The second area of strain in 2009, should inflation remain high and the official exchange rate remain constant, will be in locally procured items. With the FY 2008 ICASS carryover spent (and no similar carryover available for FY 2009), prices rising rapidly, and few additional opportunities to dollarize local procurement, Post may be forced to postpone planned and necessary local acquisitions, such as vehicles, and to put off facilities and maintenance projects requiring locally procured materials.
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